SEC RULE 10b-5: CONSTRUCTIVE FRAUD AND THE LIABILITIES OF FIDUCIARIES

I. INTRODUCTION

In a recent article,[1] one commentator listed six different areas in which rule 10b-5[2] has been applied by the federal courts. They are: trading on inside information, issuing misleading corporate information, tipping, market manipulations, broker-dealer violations, and corporate mismanagement.[3] Three relatively recent cases have added yet a seventh area to those listed above — the activities of fiduciaries such as executors and trustees. In the corporate mismanagement cases, the federal courts have been using rule 10b-5 as a tool to impose higher standards of fiduciary duty upon corporate officers and directors. Several famous cases can be cited as specific illustrations of this process. In *Speed v. Transamerica Corp.*[4], rule 10b-5 was used to attack a transaction in which the parent corporation failed to deal openly and fairly with the minority stockholders of a subsidiary. *SEC v. Texas Gulf Sulphur Co.*[5] condemned the activities of corporate officials trading on inside information and issuing misleading publicity to the detriment of buying and selling shareholders. The United States Supreme Court held that the complicated sets of transactions presented in *Superintendent of Insurance v. Banker's Life and Casualty Co.*[6] that amounted to corporate looting were actionable under rule 10b-5. The common thread that runs through all of the cases and dozens more like them is the idea that corporate officers owe their shareholders a high duty of candor, honesty and loyalty.

In the late nineteenth and early twentieth centuries state courts and legislatures greatly reduced the level of fiduciary duty that corporate of-

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1 Jacobs, *The Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Mismanagement*, 59 CORNELL L. REV. 27 (1973).

2 17 C.F.R. § 240.10b-5:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
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> (a) to employ any device, scheme, or artifice to defraud,
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> (b) to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or
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> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
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> in connection with the purchase or sale of any security.

3 Jacobs, *supra* note 1, at 29.

4 235 F.2d 369 (3d Cir. 1956). This is one of the last of the opinions in a large group of cases.

5 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

6 404 U.S. 6 (1971).

ficers and directors owed their shareholders.[7] Using 10b-5, the federal courts have gone a long way toward restoring the early nineteenth century idea that corporate officials are fiduciaries of their stockholders and affording the stockholders protection from breaches of fiduciary duty. The state courts have never reduced the standards of fiduciary duty that trustees and executors owe their beneficiaries. The reason for this may be that unlike the corporate shareholder, the trust beneficiary does not usually have either a vote in selecting his trustees or the ability to quickly and easily dispose of his interest and therefore, his need for protection from the trespasses of his fiduciary by the courts would seem to be correspondingly greater. Another reason might be that the economic pressures of industrial development did not focus as heavily on the primarily familial device of the trust as they did on the primarily commercial corporation. In the past, the protection of trust beneficiaries has been supplied by the state courts under their equity powers.

The federal courts have now begun to use rule 10b-5 to remedy breaches of fiduciary duty in the context of trusts and estates. At first glance, 10b-5 might seem to be an inappropriate tool for protecting the beneficiary from breach of fiduciary duty. Most courts discuss 10b-5 cases in terms of misleading or missing information which deceives someone while most frauds committed by trustees and executors involve conflict of interest transactions, not requiring the deception or acquiescence of beneficiaries since they are usually not involved in the management of the trust. Analysis of the corporate mismanagement cases reveals that, despite the courts' emphasis on deception, the basic thrust of the cases is to hold corporate officers liable for the same kinds of acts that state courts have held trustees liable for in the past. Thus, the federal courts have used rule 10b-5 to recreate in the corporate environment the levels of duty that previously existed in the field of trusts. Having done that with 10b-5, these corporate cases are now being applied to trustees in federal courts thus closing the cycle.

While the substantive grounds of fiduciary liability under rule 10b-5 are relatively easy to discern, the procedural mechanism for enforcing the duties created by 10b-5 has given the courts real problems in the 10b-5 cases against trustees. The shareholder derivative suit is a well articulated device that has received great procedural elaboration over the last century. Unfortunately, the trust analogy of the derivative suit is not as well known. Furthermore, individual suits would often be inappropriate since

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[7] Marsh, *Are Directors Trustees?: Conflict of Interest and Corporate Morality*, 22 BUS. LAWYER 35 (1966). *See also* the dissent of Brandeis, J. in *Louis K. Ligget & Co. v. Lee*, 288 U.S. 517 at 541 (1933).

multiple beneficiaries and unknown and contingent remaindermen would have to somehow share in the recovery, hopefully without frustrating the intent of the settlor.

Once the substantive and procedural problems in the application of 10b-5 to trusts have been conquered, there remains one final task — deciding whether the federal power should invade yet another area that has traditionally belonged to the states. This is the most difficult and intractable question that is raised by the application of 10b-5 to the area of fiduciary duties.

II. THE SUBSTANTIVE LAW

A. *Constructive Fraud*

Rule 10b-5 is often described as an anti-fraud rule. An analysis of the cases shows that if fraud is understood in a narrow sense, this description is only confusing. The cases concerning corporate and trust mismanagement are cases that involve breaches of fiduciary duty. The categories of fraud and breach of fiduciary duty are not mutually exclusive but rather are traditional categorizations of a spectrum of conduct.[8] Indeed, the breach of fiduciary duty was often called constructive fraud in the past. In his classic work, *Equity Jurisprudence*, Pomeroy points out that while falsehood coupled with scienter is the distinguishing feature of fraud, these elements are relatively unimportant in dealing with constructive frauds which are declared wrongful primarily on the basis of equitable notions of fairness and policy.[9]

For the purpose of understanding the trustee liability cases, the form of breach of fiduciary duty or constructive fraud that is most important is the breach of the trustees' duty of loyalty. The duty of loyalty is "a duty to the beneficiary to administer the trust solely in the interest of the beneficiary."[10] Thus, transactions that put a fiduciary in a position of conflict between his own interests and those of the persons to whom he owes his fiduciary obligations are constructive frauds. The archetypal transaction that illustrates this principle is the sale of trust property by a trustee to himself.[11] In such situations, the beneficiaries of the trust can compel the trustee to return the property to the trust or pay damages even in the absence of real economic injury.[12] This high standard of

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8 3 A. BROMBERG, SECURITIES LAW §4.7(2) (Supp. 1968).

9 3 J. J. POMEROY, EQUITY JURISPRUDENCE § 922 (5th ed. 1941).

10 RESTATEMENT (SECOND) OF TRUSTS § 170(1) (1959).

11 *Id.* § 170 comment b.

12 *Id.* § 206 comment b.

freedom from conflict of interest in fiduciary transactions lead to Cardozo's famous comment that:

> Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.[13]

B. *The Growth of Rule 10b-5 as a Rule of Fiduciary Duties*

The directors and officers of a corporation were held to this same standard of conduct in the early nineteenth century. In the late nineteenth and twentieth century, court decisions and statutes eroded the fiduciary duties of corporate officers until little remained.[14] The creation of a private right of action under rule 10b-5 has helped fill the gap in the law left by the erosion of state law duties. As early as 1961, the SEC recognized that the securities acts and especially their anti-fraud provisions were creating a whole new federal corporation law with much more rigorous concepts of fiduciary duty than prior state law had imposed.[15] The 1963 Supreme Court decision in *SEC v. Capital Gains Research Bureau, Inc.*[16] held that fraud in the securities law was a broader more flexible concept than the action of deceit was at common law. Furthermore, the Court suggested that the anti-fraud provisions of the securities acts should be interpreted broadly and remedially "as the courts had adapted it [equitable concepts of fraud] to the prevention of fraudulent securities transactions by fiduciaries. . . ."[17]

The federal courts of appeals, despite the growth of fiduciary duties under 10b-5, clung to the notion that fraud under 10b-5 must include deception *i.e.*, misleading information, and in so doing created a great many analytical problems. In 1964, the Second Circuit decided two cases in the area of corporate management that were to cause analytical problems for years. Both *O'Neill v. Maytag*[18] and *Ruckle v. Roto American Corp.*[19] were derivative suits in which directors were accused of constructive fraud. In *Ruckle*, the plaintiff, a director of Roto American al-

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13 Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928).

14 Marsh, *supra* note 7.

15 Cady, Roberts & Co., 40 SEC 907 (1961).

16 375 U.S. 180 (1963).

17 *Id.* at 195. *See* Patrick, *Rule 10b-5 Equitable Fraud and Schoenbaum v. Firstbrook: Another Step in the Continuing Development of Federal Corporation Law*, 21 ALA. L. REV. 457, 470 (1969).

18 339 F.2d 764 (2d Cir. 1964).

19 339 F.2d 24 (2d Cir. 1964).

leged that the defendants, who were the other directors of Roto American, caused the corporation to issue 75,000 shares to Walton, Roto American's president and a member of the board, for an inadequate consideration and for the purpose of perpetuating his control of the company. A panel of the Second Circuit held that there was a cause of action if the board of directors issues to its own members shares of the company's stock.[20] Essentially it was a holding that self-dealing transactions are constructive frauds in violation of rule 10b-5. In the *O'Neill* case, the plaintiffs contended that the board of directors of National Airlines consented to an unfavorable unwinding of an uncompleted merger in order to preserve their control of the company. Another panel of the Second Circuit, including two of the judges who sat in the *Ruckle* case, held that there was no violation of rule 10b-5 because there were no allegations "of facts amounting to deception."[21] This position has a certain surface logic if one adheres to the theory that the board of directors *is* the corporation, thereby making it unreasonable to hold that the board of directors could deceive itself.

In *Ruckle*, the court said that "when it is practical as well as just to do so, courts have experienced no difficulty in rejecting such cliches as the directors constitute the corporation and a corporation, like any other person, cannot defraud itself."[22] The court in *O'Neill* tried to distinguish that case from *Ruckle* by pointing out that there were allegations in *Ruckle* that the majority of the board was involved in the allegedly fraudulent transaction.[23] Some judges in other circuits found this distinction to be lacking in real difference. In *Dasho v. Susquehanna Corp.*,[24] two of the three judges sitting on a Seventh Circuit panel wrote a concurring opinion stating that misuse of the directors' power without deception was, by itself, a fraud under rule 10b-5. They disposed of *O'Neill* with the observation that:

> "[T]he failure of the defendant directors to perform their duty presumably injured the corporation, and I do not believe it is sound to differentiate between situations where the directors are unanimous in wrongdoing and those where less than all were involved."[25]

Other circuits tried to find a way to harmonize their conclusion that *O'Neill* type situations were violative of 10b-5 with the idea that a cause

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[20] *Id.* at 29.
[21] 339 F.2d at 768.
[22] 339 F.2d at 29.
[23] 339 F.2d at 768.
[24] 380 F.2d 262 (7th Cir. 1967), *cert. denied*, 389 U.S. 977 (1967).
[25] *Id.* at 270.

of action under the rule must include deception.[26] The court suggested that the shareholders should be regarded as taking the place of the corporate entity so that the directors were deceiving them rather than the corporation.[27]

Something of a conceptual break-through occurred in the Second Circuit with the case of *Schoenbaum v. Firstbrook*.[28] The complaint alleged that the directors of Banff sold treasury shares to Aquitane, which had three representatives on Banff's board and which owned a controlling interest in Banff, and that the consideration for the purchase was inadequate. A panel of the Second Circuit upheld a summary judgment for the defendant on the grounds that there were no allegations that the corporation was deceived since it appeared that the directors were fully informed. Judge Hays dissented and argued:

> "What the majority is actually saying is that since the directors were the corporation for the purposes of the questioned transactions the corporation must have known what the directors knew. There is, of course, no justification for interposing the corporate fiction between the directors and the minority stockholders who were the victims of the directors' fraudulent actions. In order to establish fraud it is surely not necessary to show that the directors deceived themselves. It must be enough to show that they deceived the shareholders, the real owners of the property with which the directors were dealing."[29]

A rehearing was granted and the decision was reversed with Judge Hays writing the new majority opinion. In that opinion the court held that it was an "act, practice or course of business which operates . . . as a fraud" upon Banff, for Aquitane as a controlling shareholder, to exercise "a controlling influence" over Banff's board with respect to the issuance of Banff's stock to Aquitane.[30] With this opinion the Second Circuit joined the other circuits in condemning self-dealing transactions under rule 10b-5 as constructive fraud.[31]

The analytical framework used to reach this result created almost as

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[26] Shell v. Hensly, 430 F.2d 819 (5th Cir. 1970); Pappas v. Moss, 393 F.2d 865 (3rd Cir. 1968).

[27] Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968).

[28] 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969). This is the *en banc* rehearing of the opinion at 405 F.2d 200 (2d Cir. 1968).

[29] 405 F.2d 200, 215 (2d Cir. 1968).

[30] 405 F.2d 215, 219 (2d Cir. 1968). The first part of the quoted language is from rule 10b-5(3).

[31] In Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972) a panel of the Second Circuit sharply limited *Schoenbaum*; however, it must be remembered that *Schoenbaum* was an *en banc* opinion. Furthermore, in the recent case of Schlick v. Penn-Dixie Corp., [1973-74 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,853 (2d Cir. Oct. 31, 1974) another panel of the Second Circuit followed *Schoenbaum* in a factually similar case.

many problems as the one that had been used to prevent it. Judge Hays' notion in his dissent to the first *Schoenbaum* opinion that the stockholders were deceived is of as little analytical value as Judge Lumbard's majority opinion that the directors could not deceive themselves. In the first *Schoenbaum* opinion the strained use of legal fiction is clear evidence that Judge Lumbard was trying to restrict the plaintiff to a state court action for a breach of fiduciary duty action. In Judge Hays' dissent, the creation of a new fiction should start a search for a better rationale. Clearly, the minority shareholders weren't being deceived. Even if they were omniscient there was nothing they could have done except sue, which is precisely the action they took.

The answer to the problem is indicated in the second *Schoenbaum* opinion. What had been condemned in this line of cases was not deception but rather "a device, scheme, or artifice to defraud."[32] The language of clause (c) of rule 10b-5[33] lends further support to this line of cases. Clause (c) uses the words "fraud" and "deceit" disjunctively. This can be interpreted to indicate that the word fraud means something more than the misrepresentation implied by the use of the name of the common law cause of action for misrepresentations, "deceit." The self-dealing transactions in these cases do not involve misrepresentation, but since they are constructive frauds, they arguably are well within the boundaries of "an act which operates as a fraud."

The Supreme Court removed whatever doubts remained about this kind of an expansive construction of rule 10b-5 in *Superintendent of Insurance v. Bankers Life & Casualty Co.*[34] The facts of the case are difficult to comprehend,[35] but the ones necessary to understand the holding are that Bankers Life sold all of the stock of Manhattan Casualty Co. for five million dollars to Begole. Begole took control of Manhattan and paid for the stock by selling Treasury bonds owned by Manhattan. The Second Circuit dismissed the section of the complaint dealing with the transaction on the grounds that there was no deception, and that rule 10b-5 did not deal with breaches of fiduciary duty by corporate officers.[36] The Supreme Court reversed. Justice Douglas' majority opinion stated that "the controlling stockholder owes the corporation a fiduciary obliga-

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32 17 C.F.R. §240.10b-5 (a): "to employ any device, scheme, or artifice to defraud, ..."

33 *Id.*

34 404 U.S. 6 (1971).

35 Roantree, *The Continuing Development of Rule 10b-5 as a Means of Enforcing the Fiduciary Duties of Directors and Controlling Shareholders*, 34 U. PITT. L. REV. 201 has a useful diagram of the facts in the case at p. 212.

36 Superintendent of Insurance v. Bankers Life & Casualty Co., 430 F.2d 355 (2d Cir. 1970).

tion. . . ."[37] Furthermore, in his discussion of the purpose behind the enactment of the Securities Exchange Act of 1934, Justice Douglas quoted the legislative history of the act stating that: " 'disregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless web' along with manipulation, investors' ignorance and the like."[38] The facts in the case are undoubtedly closer to corporate looting and waste than to the less spectacular kind of self-dealing found in *Schoenbaum*, but the language of the opinion leaves little doubt that the Court meant that breaches of fiduciary duty by corporate officials are fully covered by rule 10b-5.[39]

This broad approach was followed by the Eighth Circuit in *Travis v. Anthes Imperial Ltd.*[40] where the court held in the context of a tender offer that

> the self dealing alleged to exist here constitutes conduct actionable under §10(b) and Rule 10b-5. See Sup't of Insurance v. Bankers Life & Cas. Co., *supra* at 10, 92 S.Ct. 165. Here, as in *Sup't of Insurance*, the defendants' self dealing was a violation of a fiduciary obligation to minority shareholders and not just 'mere internal corporate mismanagement.' "[41]

It should also be noted that the securities transaction at issue in *Bankers Life* involved assets and not securities issued by the corporation. This is factually closer to the typical case of trustee misfeasance than those cases that involve a 10b-5 violation by an issuer in connection with its own shares such as *Schoenbaum* and *Ruckle*. Furthermore, the Court found it irrelevant that the transaction was not a typical fraud, and did not affect the securities trading process. Thus the Supreme Court gave wide scope to both the prohibitions of rule 10b-5 and the persons protected by it.

C. *The Extension of Rule 10b-5 to Trust Management*

There have been three cases where a fiduciary has been held liable under 10b-5 for constructive frauds. Two of them are district court cases and one a court of appeals case. The first case to hold a fiduciary liable for his conduct under rule 10b-5 was *Heyman v. Heyman*.[42] The plaintiff in the case was Alice Heyman. Her father, Oscar, was a shareholder along with the other members of his family in a close corporation, Oscar

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[37] 404 U.S. at 12.
[38] *Id.* at 11.
[39] *Id.* at 13.
[40] 473 F.2d 515, 527 (8th Cir. 1973).
[41] *Id.* at 527.
[42] 356 F. Supp. 958 (S.D.N.Y. 1973).

Heyman and Brothers. Oscar Heyman's stock was the subject of a repurchase agreement that obligated the corporation to buy his stock upon his death for its fair market value. The executors of the estate included one of Oscar's brothers. The trustees of a trust created by his will were Alice's brothers and a bank. Alice was a beneficiary of the trust. After Oscar died, the executors executed the repurchase agreement at a price equivalent, not to the fair market value of the stock, but to its book value. Much was made in the complaint of the allegedly fraudulent actions that the defendants took to get Alice's signature on the sale agreement despite the fact that her signature was unnecessary. The proceeds, which the complaint alleged were less than ten percent of what was due, were then deposited in the trust created by Oscar Heyman's will.

The opinion of the district court denied the defendants' motion to dismiss. The two chief defenses that the court dealt with were the "*Birnbaum*" doctrine and the asserted insufficiency of causation between any statements made to Alice and the transaction in question. Since the *Birnbaum* problem goes to the question of who is entitled to enforce liabilities, consideration of it will be deferred.[43] As for the defense that the alleged misrepresentations to Alice did not proximately cause the transaction complained of, the court's treatment demonstrates the prevailing confusion over the nature of fraud under 10b-5 and the ability of the courts to reach the right results despite the confusion.

The gist of the complaint was that the defendants fraudulently induced Alice into signing the sale agreement and failed to provide her with material information about the transaction. The defendants asserted that since Alice's signature and approval were not required in any way to consummate the transaction, their alleged misrepresentations did not cause, in a "but for" sense, the injury that was alleged.[44] The defendants relied upon a group of cases lead by *Barnett v. Anaconda Co.*[45] In that case the plaintiff sued for damages resulting from the dissolution of an Anaconda subsidiary in which he was a minority shareholder. The district court, acting on the assumption that the 10b-5 cause of action requires a material misrepresentation of fact causing injury to the plaintiff, dismissed the complaint for failure to allege sufficiently causation-in-fact. The court in *Barnett* gave as its reason the fact that

> Anaconda could have consummated the transaction regardless of minority opposition, had it existed, and no internal corporate procedures under Delaware law were available to the minority to block it. The deception alleged in the case at bar neither brought about nor contributed

[43] *See* text at note 63 *infra.*

[44] *Heyman*, note 42 *supra*, at 966.

[45] 238 F. Supp. 766 (S.D.N.Y. 1965).

> to the damage claimed to have been suffered either by the minority in the representative claim or by the corporation in the derivative claim.[46]

The court in the *Heyman* case, however, could not bring itself to buy this nice but tough bit of logic. In rejecting *Barnett* as the controlling authority in this case, Judge Bauman unfortunately did not hit upon a simple analysis. He decided that another line of cases that hold that the stockholders' ability to take non-voting legal and financial action to block a transaction is a sufficient grounds upon which to find "but for" causation. In other words, but for defendants' misrepresentations, plaintiffs would have sued to prevent the transaction. Furthermore, Judge Bauman found that Justice Douglas' comment in *Bankers Life* to the effect that rule 10b-5 protects creditors as well as stockholders was enlightening. The judge went on to point out that:

> Such parties were no more capable of preventing the Manhattan bond sale than Miss Heyman was of blocking the resale of her father's stock. The Court by implication rejected the argument that the possession of power to effect a transaction insulates the perpetrators against subsequent charges of fraud. Because the Court did not dwell on this point, and did not even refer to the *Barnett* line of cases, one cannot be confident that it intended to repudiate them. It is however reasonably clear that *Bankers Life* comes down on the side of the broader view of causation that I have adopted.[47]

The concession that the creditors in *Bankers Life* were unable to block the transaction in any way should have demonstrated to the judge that his approach to the problem was materially misleading him. The problem is, of course, that the conception of rule 10b-5 that he applied was too narrow. Seen as a problem of breach of fiduciary duty there is no causation difficulty. The position of George Heyman as both executor of Oscar Heyman's estate and president of the purchaser of the assets of the estate causes the transaction to be inherently fraudulent, and therefore the alleged misrepresentations were mere surplusage and the question of causation in fact was moot. The conflict of interest made the transaction fraudulent within the reach of rule 10b-5 just as the transactions in cases like *Schoenbaum* because such transactions constituted a constructively fraudulent breach of the duty of loyalty. Thus the allegations of misrepresentations to Alice were irrelevant, since the transaction would be equally fraudulent if she had not participated at all. Seen from this viewpoint, *Heyman* demonstrates at once both the nature of the fiduciary duty imposed upon the defendants and the confusion that arises from failure to recognize it for what it is.

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46 *Id.* at 776.

47 356 F. Supp. at 968.

The next case to deal with trustee liability under rule 10b-5 was *James v. Gerber Products, Inc.*,[48] a court of appeals decision from the Sixth Circuit. According to the complaint, Sue Ellen Banker James was one of three remaindermen beneficiaries of the separate trusts established by the respective wills of Helen Gerber and Cornelius McCarty.[49] The Old State Bank of Fremont, Michigan, one of the defendants in the case, was co-trustee with Mr. Schuiteman in 1966 and 1967 and became sole trustee of both trusts in 1968 after Schuiteman's death. In 1964, the two trusts held 57,670 of the approximately 8.5 million shares of Gerber Products' outstanding common stock. Plaintiff alleged that the bank sold 16,000 shares in 1966, 5,000 in 1968 and 1,000 in 1969, to Gerber Products at the then prevailing market prices.[50] At the time of the transactions, the general counsel of Gerber Products and one of the members of the board of Gerber Products were on the bank's five member trust committee. Furthermore, the same person was chairman of the boards of directors of both Gerber and the bank, while three of the other twelve members of the bank's board of directors were officers of Gerber. The plaintiff claimed that this substantial interlocking of the two entities created a conflict of interest that made the transactions inherently fraudulent under rule 10b-5.

The complaint put forth theories of recovery based on both rule 10b-5 and state law, the state law theory being brought under pendent jurisdiction. The prayer for relief asked either that the stock be restored to the trusts or that a $250,000 cash equivalent be paid to the trusts, as well as replacement of Old State Bank by another trustee. The complaint did not ask that any damages be paid directly to plaintiff even though it was phrased as being on her own behalf. The defendants moved to have the case dismissed by the district court on the grounds that plaintiff had no standing to sue under rule 10b-5, because she was not a purchaser or seller of securities. The district court dismissed the 10b-5 claim for lack of standing and, consequently, the state law claim for lack of subject matter jurisdiction. Plaintiff appealed the dismissal.

In reversing the district court, the Sixth Circuit focused most of its efforts on refuting the defendants' contention that the plaintiff had no standing to bring the action under the *Birnbaum* doctrine. The defense of lack of causation that caused so much difficulty in *Heyman* was either not raised by the defendants or not discussed by the court. The Sixth Circuit said quite simply: "The trustee's promotion of any interest other

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48 483 F.2d 944 (6th Cir. 1973).

49 A copy of the complaint was furnished to the author by counsel.

50 The court ignored a 1,000 share sale in 1969.

than the beneficiary's, such as its own, would be fraudulent."[51] The lack of analysis leaves the impression that the court considered the issue of whether or not rule 10b-5 had been violated on the facts of the case to be too elementary for a detailed discussion. Unfortunately, as the court in *Heyman* demonstrated, this is far from being true. Furthermore, the *James* court made at least one bow in the direction of the *Heyman* court's analysis when it noted that Ms. James did not claim to have any knowledge of, or power to affect the transactions in question, but that had she been forewarned she would have tried to block them. Fortunately, the court did not try to push this line of reasoning very far.

A satisfactory analysis could have proceeded by showing how rule 10b-5 had been used in the corporate mismanagement cases to remedy constructive frauds by corporate officers. The court could also have pointed to its own definition of constructive fraud from the common law corporate case of *Seagraves Inc. v. Mount*:

> [A]cts which may have been done in good faith, with no purpose to harm the corporation, but which are done by one who has placed himself in a position of conflict between a fiduciary obligation and his own private interests.[52]

Furthermore, the court could have pointed to at least one state law case in which an almost identical transaction was held to be fraudulent. In *Shanley's Estate v. Fidelity Union Trust Co.*,[53] the New Jersey vice-chancellor held that it would be improper for the trust company to sell some of the securities that made up the trust where a half dozen or more members of the board of directors were members of the board of directors of the company that wanted to purchase the shares. The *James* case is factually almost identical with *Shanley's Estate* and fits quite well within the definition of constructive fraud given in the *Seagraves* case and discovered in the line of rule 10b-5 cases.

The most recent and perhaps most portentous case in this series is *Local 734 Trust v. Continental Illinois Bank and Trust Co.*,[54] a district court decision from the Seventh Circuit. The reported case is a decision ruling on, and for the most part denying, motions to dismiss in a group of five related cases. The plaintiffs in the case were union pension funds which had entered into various different types of relationships with the defendant bank. For some of the pension funds the bank was an agent with the discretionary power of investment, for others, it was a trustee.

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[51] 483 F.2d at 949. This must be regarded as a holding since if the court had thought otherwise, it would have been obligated to sustain the district court's dismissal.

[52] 212 F.2d 389, 397 (6th Cir. 1954).

[53] 108 N.J. Eq. 564, 138 A. 388 (1927).

[54] ['73-'74 Transfer Binder] CCH FED. SEC. L. REP. 94,565 at 95,955 (May 10, 1974).

The complaints alleged that the bank had loaned substantial amounts of money to the Penn Central Railroad and that, in the process of making the loans, it had learned detailed inside information about the railroad. The complaint urged that there were inherent conflicts of interest between the bank's position as a creditor in its own right and its position as a trustee holding stock for the benefit of others. The plaintiffs also alleged that although the bank knew that the railroad was on the brink of collapse, it bought common stock in Penn Central for the trust account. There was also a count in one of the complaints that alleged that the bank lost a large sum of money in the stock of Management Assistance Inc., an enterprise whose principal creditor was the bank. Other counts of one of the complaints alleged similar problems with the shares of other companies.

Although the defendants raised the purchaser-seller requirement of the *Birnbaum* case as a defense, the court was able to brush it aside because of the recent Seventh Circuit holding that *Birnbaum* was not the law in the Seventh Circuit.[55] In dealing with the main substantive problem raised by the complaint, the court first disposed of the contention that the complaints stated causes of action "merely" for breaches of contract and fiduciary duty and not for violation of rule 10b-5 by noting that the Supreme Court had stated in the *Bankers Life* case that when rule 10b-5 was violated the federal courts would give a remedy notwithstanding the availability of a state court remedy.

The court, however, was not so firm in finding a theory to support the complaint. It began by leaning in the direction of accepting nondisclosure of the conflict of interest as the basis of rule 10b-5 violation by saying:

> [T]his Court deems the defendant's alleged nondisclosure as trustee or agent viz-a-viz the plaintiff as beneficiaries and principals, to fall within the ambit of Federal securities law.[56]

Then, in the next paragraph it quoted *Bankers Life* and cited *Ruckle* and *Schoenbaum*. The court reached its conclusion that the complaints state a claim upon which relief can be granted by pointing out the essential similarity of *Heyman* and *James*:

> The defendant Bank endeavors to distinguish the latter case [*James*] by noting that the trustee and the purchaser of stock were intertwined through an interlocking directorate, whereas the fraud alleged in the instant case is unilateral. We do not feel this is a cogent distinction. On the contrary, the facts in the *James* case seem quite analogous to those in

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[55] Eason v. G.M.A.C., 490 F.2d 654 (7th Cir. 1973) *cert. denied*, 416 U.S. 960 (1974).
[56] *Local 734 Trust, supra* note 52, at 95,959.

> the instant suit. *Both involve what are essentially fiduciary breaches and the corporate entanglement in* James *is rather similar to the complex commercial involvement the Bank is alleged herein to have had.* Therefore, there may be Federal securities fraud regardless of whether the means to accomplish it is unilateral or involves a third party buyer or seller.[57]

The court recognized that the complaint before it and the *James* case were both for breach of fiduciary duty and that such an act constituted a violation of rule 10b-5.[58] The court concluded by rejecting the bank's attempt to claim an immunity from rule 10b-5 under the banking laws.[59]

The consequences of this decision, if upheld and followed, will be far reaching. The dual role of banks as trustees and creditors has not drawn that much scrutiny in recent years. It is easy to see that the interests of creditors and shareholders are often at odds. The creditor will often insist that common stockholders agree to limit their dividends as part of the loan agreement. In some cases, the creditors will insist upon the granting of mortgages as security, and, in other cases, the control over the company itself may be pledged. If worse comes to worse and the enterprise becomes insolvent, as happened to the Penn Central, the stockholders may have to engage in a lengthy battle with the creditors to get anything out of reorganization or bankruptcy proceedings. Furthermore, even when the trust holds debt securities they will often be of a different class of priority than the bank's claim. Finally, the bank may be inhibited by rule 10b-5 itself from properly performing its duties as a trustee and selling a stock if it is in possession of "inside information."[60] Where the legal owner of the securities in any of the situations is a bank acting as a trustee, while the creditor is the bank acting in its own right, the conflict of interest thus created is, according to *Local 734 Trust*, a potential violation of rule 10b-5 that becomes actual when a transaction is consummated. It is perfectly legitimate to wonder how, in the face of this decision, banks can continue to operate trust companies. Given the logic of the holding in *Local 734 Trust*, it would seem that the only prudent course open to banks is to divest their trust operations. It would furthermore seem logical that the only way a corporate trustee can avoid the reach of rule 10b-5 in the future is to avoid at all costs entanglement in conglomerate financial enterprises that create conflicts of interest.

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[57] *Id.* [Emphasis added].

[58] Because the trusts in this case were pension funds they would also fall under the Employee Retirement Income Security Act of 1974, §§ 401-414, 88 Stat. 829, in any future cases.

[59] The position that banks are not immune from rule 10b-5 was also championed by SEC Chairman Ray Garret, Jr. in a speech given in San Francisco on February 4, 1974. *See* Boise-Cascade Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. 79,461 at 83, 291 (1973).

[60] SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968); Investors Management Co., Inc. SEC Holding Co. Act Release No. 9267 (July 29, 1971).

III. STANDING TO SUE

Although the courts have now reached the conclusion that for a fiduciary to breach his duty of loyalty to his beneficiary is a violation of rule 10b-5, they have not been quite so adept at finding exactly the right solution to the problem of who has the right to enforce this duty. It is easy enough to see in the abstract what a logical solution to this problem should be. A typical private trust arrangement may have one or more life beneficiaries who are succeeded in interest by one or more remaindermen whose interests may be either vested or contingent and who may or may not exist yet. Furthermore, there are often powers of appointment and gifts over to charitable institutions to complicate this arrangement. It is obvious that if one of the beneficiaries in possession is allowed to sue a malfeasant trustee and recover damages for his own use and benefit, several undesirable consequences follow. First, the interest of the remaindermen has been reduced without compensation. Second, the funds may be given to a person who is not competent to manage them. Third, the settlor's plan is frustrated. Fourth, even if the funds are impressed with a trust, the management may have been made much more complicated by having two trusts instead of one. These considerations plus the fact that any damages suffered are suffered by the trust *res*, indicate that any damages that accrue should be paid into the trust. Furthermore, if the transaction is being rescinded, the appropriate way to unwind the transaction is to return the securities in question to their place of origin—the trust. Finally, the analogy of the corporate derivative suit, which is common in 10b-5 cases, and state law practice should be persuasive. The logical solution then is for the trust beneficiary to bring suit against the trustee on behalf of the trust.

Unfortunately, the first time this theory was advanced it was rejected by a district court in Colorado. In one part of the opinion in *Rippey v. Denver U.S. National Bank*,[61] the court refused to allow the plaintiff-beneficiaries to proceed on behalf of the trust against the trustees for violation of rule 10b-5 because, the court said, a trust is not a person within the meaning of 10b-5. The holding is clearly wrong since there is nothing in the text of rule 10b-5 or the case law under the rule that requires a plaintiff in a 10b-5 action to be a "person."[62] Furthermore, the court ignored the Supreme Court's often quoted instruction to interpret the securities laws liberally.[63] It should be pointed out that *Rippey* was decided in 1966, at the very beginning of the great expansion of rule

[61] 260 F. Supp. 704 (D. Colo. 1966).

[62] 1 A. BROMBERG, SECURITIES LAW *Fraud: SEC Rule 10b-5* 79 n.50.1.

[63] Jacobs, *supra* note 1, at 22.

10b-5, and is only a district court case. It would therefore seem that the wisest thing to do with the decision would be to ignore it.

The court in *Heyman* did repudiate the other part of the decision in *Rippey* that held that the plaintiffs could not bring the action as individuals, since they had not been defrauded as individuals. Unfortunately, the judge also added in a footnote his comment that

> Nothing in what I have said should be construed as endorsing plaintiff's contention that she may maintain a *derivative* action on behalf of the estate. I am not convinced by plaintiff's argument that such an action is closely analogous to a shareholders' derivative suit. See Rippey v. Denver National Bank, supra, note 8 at 715.[64]

As discussed above, this is not the logical solution to the problem, but it is the solution which prevailed. Since neither *James* nor *Local 734 Trust* discussed this problem, and since the question is still unsettled, the logical solution may still prevail in the future.

By forcing the beneficiary to sue as an individual the courts have created still another problem. The so-called *Birnbaum* doctrine, or the purchaser-seller rule, requires that a plaintiff in a 10b-5 action must be either a purchaser or a seller in the transaction complained of.[65] The rule is shot full of exceptions,[66] has been declared dead in at least one circuit[67] and has been criticized by the S.E.C. and commentators.[68] It would not be a problem in these cases if the beneficiary were conducting a derivative suit because the requirements of the rule would be satisfied by the fact that the trust was a seller. If, on the other hand, the beneficiary is suing as an individual instead of on behalf of the trust, then there is a problem with *Birnbaum* since the individual was not the seller. The court in *Local 734 Trust* felt it could ignore the problem because *Birnbaum* is not the law in the Seventh Circuit. The courts in *James* and *Heyman* preferred to argue around *Birnbaum*. Since they should not have considered the purchaser-seller problem at all, it is really not very important how they got themselves out of it. In the end, both courts concluded that as a matter of policy they should at least make another exception to the purchaser-seller rule since if they did not there would be a wrong with-

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[64] *Heyman*, 356 F. Supp. at 966 n. 10.

[65] Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952).

[66] Vine v. Beneficial Finance Co., 374 F.2d 627 (2d Cir. 1967); A. T. Brod Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967); Mutual Shares Corp. v. Genesco Inc., 384 F.2d 540 (2d Cir. 1967).

[67] Eason v. G.M.A.C., 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

[68] Rekant v. Desser, 425 F.2d 872 (5th Cir. 1970); Kellog, *The Inability to Obtain Analytical Precision Where Standing to Sue Under Rule 10b-5 Is Involved*, 20 BUFFALO L. REV. 93 (1970); Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968).

out a remedy and the policy of *Birnbaum*, whatever it may be at this date, does not command otherwise. Thus, the *James* and *Heyman* courts were able to maneuver themselves out of a bind that other courts in the future should not maneuver themselves into.

IV. Policy Considerations Behind the Use of Rule 10b-5 in Breach of Fiduciary Duty Cases

The implications of the cases that have been discussed are clear. Assuming that the jurisdictional means have been established,[69] trust beneficiaries will be able to sue their trustees for constructive fraud in the federal courts instead of the state courts. The practical import of this is obvious to most attorneys. Certainly the attorneys in *Heyman*, *James* and *Local 734 Trust* cases were looking for some advantage in filing their complaint in federal court rather than the local probate or general jurisdiction court. Since it does not seem that there is any real difference between the state and the federal substantive laws in these cases, the attorneys must have been looking for some procedural or practical advantage. Two immediately obvious procedural advantages are the wider availability of jury trial in federal court[70] and the broader scope of federal court discovery rules.[71] On the practical side, they might also have desired to obtain what many attorneys believe is the preferable atmosphere of the federal courts. Whatever their reasons for seeking their remedy in federal court, the plaintiffs and their attorneys were allowed to stay and will surely be followed by others. The question becomes one of the wisdom of a group of decisions that will increase the federal role in regulating yet another area of activity.

There are at least two sets of reasons why the federal courts should not intervene in the area of trust management. The first one relates to the particular problems inherent in the use of the securities laws and 10b-5 as the substantive law in the field; the second goes to more traditional concerns about federal-state relations. As to the second set of concerns, our attention must be focused on the quality of the state's interest and the adequacy of the remedies the states provide as well as the problem that the federal courts would face. The management of trusts

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[69] This may be a non-trivial problem. Imagine the trustee who deals with himself by taking things out of one desk drawer and putting them into another without using any exchange or the mails, etc.

[70] For example, the rule in Michigan where *James* occurred is given in *Abner A. Wolf Inc v. Walch*, 385 Mich. 253, 188 N.W.2d 544 (1971). *Compare* Ross v. Bernhard, 396 U.S. 531 (1970). The Michigan approach is less expansive.

[71] *Compare* MICH. GEN. CT. R. 302.2, which limits depositions to material that is relevant and admissible, *with* FED. R. CIV. P. 26(b)(1).

is an area of the law in which the federal courts have always been reluctant to intervene—the creation and transfer of property rights. One example of this reluctance has been the refusal of the federal courts to entertain some types of probate actions under diversity jurisdiction.[72] Furthermore, it is an area that often involves family relationships, such as marriage arrangements, which are more within the competence of local courts than the often physically distant federal courts. Furthermore, the states have not been negligent in protecting the trust beneficiary. In the case of corporate officers and directors, decisions and statutes have eroded the duties they owe shareholders under state law thus leaving a great vacuum for federal law to fill. In the area of trusts, however, there has been little, if any, of the " 'disintegrating erosion' of particular exceptions."[73] This is illustrated by the fact that the same facts that made up the 10b-5 claim in *James* were also pleaded as a state law claim for relief. The Supreme Court in *Bankers Life* said that ". . . there is redress under § 10(b), whatever might be available as a remedy under state law."[74] But this cannot mean that the courts cannot consider the adequacy and availability of state court remedies when determining whether or not to extend rule 10b-5 into new areas. Certainly, the number of federal judges and the amount of their time is limited. Complaints are constantly heard about the "overloading" of federal courts at all levels from the Supreme Court on down. If these complaints are true, then the federal courts should be hesitant to take on a job that the states are already doing and to all appearances doing satisfactorily.

The use of federal securities laws to regulate trust management raises several problems that should give the courts pause before they proceed to use them. The largest difficulty is that the rights and remedies of beneficiaries and the duties and liabilities of trustees will depend upon the nature of the trust *res*. To use the *James* case as an example, if the trustees had sold Gerber a plot of land in a fourth transaction along with the three stock transactions, the plaintiff might have had to go to state court on the land transaction while staying in federal court on the securities law claim.[75] The possibilities of inconsistent determinations of fact and law relating to otherwise identical transactions because they are in

[72] Vestal & Foster, *Implied Limitations on the Diversity Jurisdiction of Federal Courts*, 41 MINN. L. REV. 1 (1956).

[73] Meinhard, *supra* n. 13. See generally 2 A. SCOTT, TRUSTS § 170 (3rd ed. 1967).

[74] *Supt. of Ins. v. Bankers Life*, *supra* n. 6, at 12. One would hate to think of the consequence of returning to the bad old days of "adequate remedies at law" and what that would do to the already confusing field of federal jurisdiction.

[75] The result might turn on the facts. If the sales of stock and land were factually intermeshed, the court might accept pendent jurisdiction. Errian v. Cornell, 236 F.2d 447 (9th Cir. 1956).

different courts would be disturbing. This situation can only be worsened by the exclusive jurisdiction provisions of the Securities Exchange Act of 1934.[76] These provisions could cause confusion because the mere change in the theories of the pleadings will deprive the state courts of jurisdiction over matters traditionally within their jurisdiction. That such a slight change in the theory of the pleadings should make such a large difference is also troublesome. If the inquiry were dropped at this point, the cases that have been discussed would have to be condemned as unwise excursions by the federal courts into a traditional domain of state law in which the securities laws are a poor vehicle to use to reach a just result; however, the inquiry can not stop here but must be pressed onward to consider what factors might make the decisions seem wise.

On the other side of the argument, a recent Senate committee report points out that there are twenty-eight institutional investors with assets of over five billion dollars.[77] Some of this money is not invested in securities, and some of the institutions are already regulated in their activity by parts of the federal securities laws and the federal banking laws. Much of the money is held in trusts in the form of securities. The report gives as an example the Burlington Northern Company. Of the thirty largest holders of its common stock, eleven are nominees of four banks acting as trustees.[78] The report points out, based on Burlington Northern and some other companies, that there is a very serious possibility that this type of situation combined with interlocking directorates and other financial transactions such as loans and deposits make "it difficult to avoid self-dealing on the basis of inside information."[79] This is a problem of the scope, complexity and economic importance which may well justify the intervention of federal power.

To the task of coping with the challenge presented by the Senate committee's report, the federal bench brings two important qualifications. The first one is independence. No matter how honest he is, the state court judge may very well be reluctant to find that some of the most prominent citizens of his community have been guilty of wrongdoing. Furthermore, the need to get re-elected introduces disturbing pressures into any system. The pressure of trying to preserve a local economy may also tempt state judges and legislators to subject the relevant law to "disintegrating erosion." The federal judge appointed for a lifetime and re-

[76] Securities Exchange Act of 1934, § 27, 15 U.S.C. § 78aa (1971).

[77] B.N.A. SEC. REG. LAW. R. No. 234, January 9, 1974, at G-1. *See also* Lybecker, *Regulation of Bank Trust Department Investment Activities*, 82 YALE L.J. 977 (1973). Morgan Guaranty Trust is the largest on the list with 27.4 billion dollars of assets held in trust.

[78] B.N.A. SEC. REG. LAW. R., *supra* note 75, at G-5.

[79] *Id.* at G-6.

sponsible for a nationwide law will be immune to many of these pressures.[80] The second advantage that the federal courts have is superior expertise in dealing with large-scale financial litigation. Complex and difficult fact patterns presented by these types of cases call for an ability to think in terms that are strange to the average jurist accustomed to a steady stream of criminal and negligence cases. The federal courts, on the other hand, have, because of years of securities and anti-trust litigation, developed this type of factual expertise that is unmatched in the states. Furthermore, the federal courts have achieved procedural sophistication in handling big cases. The nationwide service of process features of federal securities jurisdiction,[81] and the judicial panel on multidistrict litigation are resources that the states are inherently incapable of matching.

VI. CONCLUSION

The federal courts may very well go about creating a federal law of trusts paralleling the federal law of corporations that they have already created under rule 10b-5. Of course, the considerations discussed above may lead the courts to disregard or limit the cases. Whatever the courts do, the decisions make it clear that Congress needs to fundamentally reconsider the federal securities law. The current ALI proposal to codify the securities laws would not seem to affect the *James* decision at all.[82] While this may be laudable from the viewpoint of a codification and restatement, it does not begin to tackle the substantive policy problems raised by the development of "federal corporation law" and "federal trust law." The shape and limits of the laws are something that Congress should carefully consider. Over the last two centuries America has developed from a confederation of localities to a single national entity. Just as the activities of corporations have for that reason drawn increasing attention to the need for further federal regulation, so it would seem have the activities of trustees.

Unfortunately, the congress probably will not act on these matters very soon if at all. Therefore, the courts will be left to their own devices and given the logic of the cases they will probably continue what they have started. The results will not be completely bad if "the punctilio of an honor the most sensitive . . . ." is vindicated.

Robert S. Schwartz

[80] *See* Palmore v. U.S., 411 389, 410 (1973) (Douglas, J. dissenting).

[81] Securities Exchange Act of 1934, § 27, 15 U.S.C. 78aa (1971).

[82] *See* ALI FED. SECURITIES CODE, T.D. 2 §§ 1301, 1402.